



**DEPARTMENT OF THE TREASURY**

**INTERNAL REVENUE SERVICE**

**TE/GE: EO Examinations**

**1100 Commerce Street, MC 4920 DAL**

**Dallas, TX 75242**

**TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION**

**March 31, 2016**

**Release Number: 201627002**

**Release Date: 7/1/2016**

**UIL Code: 501.03-00**

**Taxpayer Identification Number:**

**Person to Contact:**

**Identification Number:**

**Contact Telephone Number:**

**CERTIFIED MAIL – RETURN RECEIPT REQUESTED**

**Dear :**

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (the Code). Our favorable determination letter to you dated February 19XX is hereby revoked and you are no longer exempt under section 501(a) of the Code effective January 1, 20XX.

The revocation of your exempt status was made for the following reason(s):

Organizations exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code are required to operate exclusively for charitable, education, or other exempt purposes. Organizations are not operated exclusively for exempt purposes if the net earnings of the organization inure in whole or in part to the benefit of private shareholders or individuals. See Treas. Reg. section 1.501(c)(3)-1(c)(2).

During 20XX, 20XX, and 20XX, we have determined that your net earnings inured to the benefit of private individuals because you regularly paid personal expenses for and made other disbursements to your founder without contemporaneously recording these expenditures as salary or compensation. The transactions were frequent and were significant in relation to your exempt activities in each year. No efforts were made by the board to seek correction of these transactions, no safeguards were implemented to prevent future divisions and Organization ceased operating in 20XX. You have operated for the benefit of private interests of individuals in contravention of the requirements of Treas. Reg. 1.501(c)(3)-1(d)(1)(ii).

Contributions to your organization are no longer deductible under IRC §170 after January 1, 20XX.

You are required to file Form 1120 U. S. Corporation Income Tax Return. These returns should be filed with the appropriate Service Center for tax years ended December 31, 20XX, December 31, 20XX, December 31, 20XX and for all years thereafter in accordance with the instructions of the return.

Processing of income tax returns and assessments of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Internal Revenue Code.

If you decide to contest this determination under the declaratory judgment provisions of section 7428 of the Code, a petition to the United States Tax Court, the United States Claims Court, or the district court of the United States for the District of Columbia must be filed before the 91<sup>st</sup> Day after the date this determination was mailed to you. Please contact the clerk of the appropriate court for rules regarding filing petitions for declaratory judgments by referring to the enclosed Publication 892. You may write to these courts at the following addresses:

United States Tax Court  
400 Second Street, NW  
Washington, D.C. 20217

United States Court of Federal Claims  
717 Madison Place, NW  
Washington, D.C. 20005

United States District Court for the District of Columbia  
333 Constitution Avenue, NW  
Washington, D.C. 20001

The Taxpayer Advocate Service (TAS) is an independent organization within the IRS that can help protect your taxpayer rights. TAS can offer you help if your tax problem is causing a hardship, or you've tried but haven't been able to resolve your problem with the IRS. If you qualify for TAS assistance, which is always free, TAS will do everything possible to help you. Visit [taxpayeradvocate.irs.gov](http://taxpayeradvocate.irs.gov) or call 1-877-777-4778.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Paul A. Marmolejo  
Acting Director, EO Examinations

Enclosure:  
Publication 892

**Internal Revenue Service**  
**Tax Exempt and Government Entities Division**  
Exempt Organizations: Examinations  
1100 Commerce Street, MS: 4920  
Dallas, TX 75242

**Department of the Treasury**

**Date:**

July 7, 20XX

**Taxpayer Identification Number:**

**Form:**

990

**Tax Year(s) Ended:**

December 31, 20XX

December 31, 20XX

December 31, 20XX

**Person to Contact/ID Number:**

**Contact Numbers:**

**Manager's name/ID number:**

**Manager's contact number:**

**Response due date:**

August 3, 20XX

**Certified Mail – Return Receipt Requested**

Dear :

**Why you are receiving this letter**

We propose to revoke your status as an organization described in section 501(c)(3) of the Internal Revenue Code (Code). Enclosed is our report of examination explaining the proposed action.

**What you need to do if you agree**

If you agree with our proposal, please sign the enclosed Form 6018, *Consent to Proposed Action – Section 7428*, and return it to the contact person at the address listed above (unless you have already provided us a signed Form 6018). We'll issue a final revocation letter determining that you aren't an organization described in section 501(c)(3).

After we issue the final revocation letter, we'll announce that your organization is no longer eligible for contributions deductible under section 170 of the Code.

**If we don't hear from you**

If you don't respond to this proposal within 30 calendar days from the date of this letter, we'll issue a final revocation letter. Failing to respond to this proposal will adversely impact your legal standing to seek a declaratory judgment because you failed to exhaust your administrative remedies.

**Effect of revocation status**

If you receive a final revocation letter, you'll be required to file federal income tax returns for the tax year(s) shown above as well as for subsequent tax years.

**What you need to do if you disagree with the proposed revocation**

If you disagree with our proposed revocation, you may request a meeting or telephone conference with the supervisor of the IRS contact identified in the heading of this letter. You also may file a protest with the IRS Appeals office by submitting a written request to the contact person at the address listed above within 30 calendar days from the date of this letter.

The Appeals office is independent of the Exempt Organizations division and resolves most disputes informally.

For your protest to be valid, it must contain certain specific information including a statement of the facts, the applicable law, and arguments in support of your position. For specific information needed for a valid protest, please refer to page one of the enclosed Publication 892, *How to Appeal an IRS Decision on Tax-Exempt Status*, and page six of the enclosed Publication 3498, *The Examination Process*. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process. Please note that Fast Track Mediation referred to in Publication 3498 generally doesn't apply after we issue this letter.

You also may request that we refer this matter for technical advice as explained in Publication 892. Please contact the individual identified on the first page of this letter if you are considering requesting technical advice. If we issue a determination letter to you based on a technical advice memorandum issued by the Exempt Organizations Rulings and Agreements office, no further IRS administrative appeal will be available to you.

**Contacting the Taxpayer Advocate Office is a taxpayer right**

You have the right to contact the office of the Taxpayer Advocate. Their assistance isn't a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate can't reverse a legally correct tax determination or extend the time you have (fixed by law) to file a petition in a United States court. They can, however, see that a tax matter that hasn't been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate assistance. If you prefer, you may contact your local Taxpayer Advocate at:

Internal Revenue Service  
Office of the Taxpayer Advocate

**For additional information**

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Margaret Von Lienen  
Director, EO Examinations

Enclosures:  
Report of Examination  
Form 6018  
Publication 892  
Publication 3498

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
Name of Taxpayer		Year/Period Ended DECEMBER 31, 20XX DECEMBER 31 20XX DECEMBER 31, 20XX

## ISSUES

Whether \_\_\_\_\_ should have their exemption revoked for creating private benefit and inurement to a disqualified person of the exempt organization?

## FACTS

\_\_\_\_\_ is an applicable 501(c)(3) established in \_\_\_\_\_, \_\_\_\_\_ in October 20 of 19XX. \_\_\_\_\_ was granted their exemption on October of 19XX. The purpose of \_\_\_\_\_ is to provide assistance to various municipalities around \_\_\_\_\_ that have \_\_\_\_\_ that are home to an endangered species list that lives only in \_\_\_\_\_ in the \_\_\_\_\_ area. \_\_\_\_\_ protects and inventories the \_\_\_\_\_.

\_\_\_\_\_ paid for items that benefited \_\_\_\_\_ has failed to substantiate the exempt purpose of these expenditures as requested in the issued to \_\_\_\_\_ on March 13 20XX. A listing of the largest items noted is as follows.

Meals: In 20XX food was purchased \_\_\_\_\_ times for a total of \$ \_\_\_\_\_. These purchases occurred evenly throughout the year. In 20XX food was purchased \_\_\_\_\_ times for a total of \$ \_\_\_\_\_. \_\_\_\_\_ provided bank statements showing these expenditures, but \_\_\_\_\_ was issued several \_\_\_\_\_ on requesting substantiation for the business and tax exempt purpose of said purchases, but to date has failed to provide the requested information therefore these purchases are deemed to be personal in nature benefiting \_\_\_\_\_ personally.

Cable: \_\_\_\_\_ purchased cable and internet for \_\_\_\_\_ personal residence in the years 20XX and 20XX. The total expense for each year was \$ \_\_\_\_\_ for 20XX and \$ \_\_\_\_\_ for 20XX. \_\_\_\_\_ was issued \_\_\_\_\_ requesting substantiation for the business and tax exempt nature of these expenses, however to date this information has not been provided. Therefore due to the personal nature of these expenses it is deemed to be benefiting \_\_\_\_\_ personally.

Vehicle expenses: In 20XX \_\_\_\_\_ paid \$ \_\_\_\_\_ for \_\_\_\_\_ fees, \$ \_\_\_\_\_ in gas, and \$ \_\_\_\_\_ in vehicle repairs. In 20XX \_\_\_\_\_ purchased \$ \_\_\_\_\_ in gas and \$ \_\_\_\_\_ in vehicle repair. \_\_\_\_\_ has no vehicle listed in the asset log that it provided from \_\_\_\_\_ sent on December 5, 20XX.

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All transactions provided by \_\_\_\_\_ were either cash withdraws or debit card purchases. This agent did not observe any transactions that were checks in the records for the three years under exam.

\_\_\_\_\_ was issued on March 19, 20XX requesting explanation and source of the deposits. \_\_\_\_\_ stated that the amounts deposited were personal loans made to the EO from him. Agent noted that no contemporaneous loan documents were available to substantiate the terms of the loan. The loan from the officer was determined to not be a bona fide debt. The organization did not maintain proper substantiation to support and verify the expenses and advances that made up the total balance due to the officer (such as a written promissory note, repayment schedule, maturity date for the loan, or an interest rate for the loan).

All disbursements in the bank statements provided by \_\_\_\_\_ are debit card transactions or cash transactions.

\_\_\_\_\_ provided the Service with bank statements and envelopes with receipts in them. The receipts did not match the dollar amounts of the envelopes. The receipts inside the envelopes were not always from the immediate period that the cash withdraw was made. The receipts were from as much as a year before and half a year later in the same envelope. There was no accountable plan in place at \_\_\_\_\_. Most transactions were cash transactions or reimbursements of purchases.

The Bylaws of \_\_\_\_\_ state in \_\_\_\_\_ Prohibition against Private Inurement: No part of the net earnings of this corporation shall inure to the benefit of, or be distributable to, its members, directors, or trustees, officers, or other private persons, except that the corporation shall be authorized and empowered to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of the purposes of this corporation.

The \_\_\_\_\_ of \_\_\_\_\_ provides \_\_\_\_\_ monitoring on the side and is paid directly for \_\_\_\_\_ services.

## LAW

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Section 501(c)(3) of the Code exempts from federal income tax organizations organized and operated exclusively for charitable, educational, and other exempt purposes, provided that no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the regulations provides that in order to be exempt as an organization described in section 501(c)(3) of the Code, the organization must be one that is both organized and operated exclusively for one or more of the purposes specified in that section.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will not be regarded as operated exclusively for exempt purposes if more than an insubstantial part of its activities is not in furtherance of exempt purposes.

Section 1.501(c)(3)-1(d)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. The regulation places the burden of proof on the organization to demonstrate that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled directly or indirectly by such private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense, and includes the promotion of education.

The presence of a single substantial nonexempt purpose can destroy the exemption regardless of the number or importance of exempt purposes. *Better Bus. Bureau v. United States*, 326 U.S. 279, 283, 90 L. Ed. 67, 66 S. Ct. 112 (1945); *Am. Campaign Acad. v. Commissioner*, 92 T.C. 1053, 1065 (1989); see also *Old Dominion Box Co., Inc. v. United States*, 477 F.2d. 340 (4<sup>th</sup> Cir. 1973), cert. denied, 413 US 910 (1973) ("operating for the benefit of private parties who are not members of a charitable class constitutes a substantial nonexempt purpose"). When an organization operates for the



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benefit of private interests, such as designated individuals, the creator or his family, or persons directly or indirectly controlled by such private interests, the organization by definition does not operate exclusively for exempt purposes. *Am. Campaign Acad. v. Commissioner, supra at 1065-1066.*

In *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352 (1978), the courts ruled the organization did not qualify for exemption under IRC section 501(c)(3) because it was not operated exclusively for charitable, educational, or scientific purposes.

In order to be recognized as exempt under IRC section 501(c)(3), the organization is prohibited from:

- 1) Permitting its net earnings to inure to the benefit of private individuals or operating in a way where more than an insubstantial part of its activities further private versus public purposes
- 2) Engaging substantially in legislative activity
- 3) Participating or intervening in any political activity

Treas. Reg. section 1.501(c)(3)-1(c)(2) states that an organization is not exclusively operated for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Treas. Reg. section 1.501(a)-1(c) defines a "private shareholder or individual" as "persons having a personal and private interest in the activities of an organization."

If the private benefit to an individual or a group of individuals is greater than the public benefit, the private benefit is considered substantial. A substantial private benefit can result in revocation of exempt status.

Even a small amount of private inurement is fatal to exemption. In *Spokane Motorcycle Club v. U.S.*, 222 F. Supp. 151 (E.D. Wash. 1963), net profits were found to inure to private individuals where refreshments, goods and services amounting to \$825 (representing some 8% of gross revenues) were furnished to members

Regs. 1.501(c)(3)-1(d)(1)(ii) states that the burden of proof is upon the organization to establish that it is not organized or operated for the benefit of private interests. This requirement applies equally to inurement and private benefit issues. While it is difficult to prove a negative, the organization is certainly in a better position than the Service to know the detailed facts surrounding its formation and operation. Therefore, in an

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exemption application case the organization is required to furnish the Service with the documents setting forth its purposes and rules of operation as well as a detailed explanation of its operations. See Rev. Proc. 84-46, 1984-1 C.B. 541.

*Baird v. Commissioner*, 25 T.C. 387 (1955) provides that the extent to which the borrower controls the corporation is a factor that can indicate whether a loan is a bona fide debt.

*United States v. Title Guarantee & Trust Co.*, 133 F. 2d 990 (6th Cir. 1943) provides that the maturity date of the loan can indicate whether a loan is a bona fide debt.

*Thielking v. Commissioner*, T.C.M. 1987-227 provides that whether the note provides for interest or not can indicate whether a loan is a bona fide debt.

In *John Marshall Law School and John Marshall University v. United States*, 228 Ct. Cl. 902 (1981), 81-2 U.S.T.C. 9514 involve classic channeling of an organization's net earnings to those in control. The court sustained the Service's revocation of the school's exempt status based on inurement. The court found inurement existed when the school provided the following to family members who were its officers:

- \* Interest free loans
- \* Unsecured loans
- \* Payments for non-business travel
- \* Payments for non-business entertainment
- \* Personal health spa membership

In *United Cancer Council, Inc. v. Commissioner*, 165 F.3d 1173 (1999), the appeals court stated the inurement clause of IRC section 501(c)(3) interprets the phrase "private individual or shareholder" as an insider of the charity.

The court further said a charity must not improperly pass its earnings to its founder, board members, their families, or anyone else described as an insider who is the equivalent of an owner or manager. The insider could be an employee such as an office manager.

### **GOVERNMENT'S POSITION**

An organization recognized as tax exempt under IRC section 501(c)(3) is prohibited from permitting **any** of its net earnings to inure to the benefit of any private shareholder

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or individual. records show several expenses that are inurement just like in *John Marshall Law School and John Marshall University v. United States*, 228 Ct. Cl. 902 (1981), 81-2 U.S.T.C. 9514. These expenses meals, cable bills, payments and other expenses are for the betterment of a disqualified person and not for general public.

Regs. 1.501(c)(3)-1(d)(1)(ii) states that the burden of proof is upon the organization to establish that it is not organized or operated for the benefit of private interests. This requirement applies equally to inurement and private benefit issues. While it is difficult to prove a negative, the organization is certainly in a better position than the Service to know the detailed facts surrounding its formation and operation. Therefore, in an exemption application case the organization is required to furnish the Service with the documents setting forth its purposes and rules of operation as well as a detailed explanation of its operations. See *Rev. Proc. 84-46, 1984-1 C.B. 541*.

It is the Government's position that the has not provided any consistency in the information provided in this examination. In response to the Information Document Requests, furnished several envelopes with receipts, total of which never reconciled to the amounts withdrawn from the bank account.. The receipts were from 8 months before the cash withdraw and up to 8 months after the cash withdraw. The receipts contained in the envelopes were for various expenses that were never proven to be for a business/tax exempt purpose and were dated for periods outside of the audit years. See the examples attached to this report. This is inconsistent with the meaning of an accountable plan and not proof of factual events for an ongoing concern. The receipts provided in envelopes were not labeled with information to discern their exempt purpose. To not have an accountable plan is to have a taxable event and that is what this agent sees in . Not only do we have a taxable event but we have inurement which is not allowed in Section 501(c)(3) organizations. Therefore it is the Governments position that should lose its exemption due to inurement and private benefit created on behalf of the of Disqualified Person who controls the exempt organization. All purchases and decisions are made by the of . Excess benefit transactions would not occur without approval.

The amount of the benefit is not clear due to the intermingling of personal expenses and exempt organizations functional expenses. What was determinable was that there is a comingling of these expenses and that there were no controls or accountable plans

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to separate personal expenses from the exempt organizations business. The exempt organization did not report these amounts as compensation on an original or amended Form 990, Form W-2, or Form 1099 for the year ending December 31, 20XX, before the start of this examination; nor did any of the corporate officers report these amounts as compensation on an original or amended Form 1040 before the start of this examination. Furthermore, the EO did not establish that its failure to report these amounts as compensation was due to reasonable cause within the meaning of section 301.6724-1 of the regulations, nor did it provide any other written documentation demonstrating that it approved these payments in accordance with established procedures set forth in section 53-4958-4(c)(3)(ii) of the regulations. The payments are described in detail below and on the attached documents.

The claims that certain payments received by the exempt organization were loans. As per United States v. Title Guarantee & Trust Co., 133 F. 2d 990 (6th Cir. 1943), Thielking v. Commissioner, T.C.M. 1987-227, and Baird v. Commissioner, 25 T.C. 387 (1955) the Government has a framework that must be followed to be bona fide as a true loan and not a contribution to an organization. These steps to disclose a bona fide debt such as including in the Form 990 that loans were created or a physical document signed contemporaneously that would state terms conditions and implied payback schedule were not provided. did not document the transactions contemporaneously. The of did not even leave a paper trail to proof that the moneys were from the of . The of states that withdrew the cash from personal account and deposited said cash into account. It is the Government's position that there are no loans properly disclosed to the Government, nor any contemporaneous documentation to proof the origins of the funds that were received. The corresponding cash payments made to the of will be considered unreported income therefore, as per definition Section 4958 excess benefit transactions.

## **CONCLUSION**

Regs. 1.501(c)(3)-1(d)(1)(ii) states that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. The regulation places the burden of proof on the organization to demonstrate that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or family, shareholders of the organization, or persons

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controlled directly or indirectly by such private interests. Based on the foregoing reasons, does not qualify for exemption under section 501(c)(3) and its tax exempt status should be revoked as of January 1 20XX.

should have their exempt status revoked due to lack of exempt purposes.

### **TAXPAYER'S POSITION**

has indicated that it will agree with to revocation of its exemption.